

**REPORT ON APPLYING
AGREED-UPON PROCEDURES FOR
THE KENTUCKY DEPARTMENT OF EDUCATION**

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EDWARD B. HATCHETT, JR.
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July 31, 2000

Kevin Noland
Interim Commissioner
Department of Education
Capital Plaza Tower
500 Mero Street
Frankfort, Kentucky 40601

RE: Memorandum of Agreement #00034626 – Report on Applying Agreed-Upon Procedures
for the Kentucky Department of Education (KDE)

Dear Commissioner Noland:

We performed the procedures enumerated below, which were agreed to by KDE, solely to assist you in evaluating KDE's internal controls governing receipt and disbursement activity between KDE and the educational co-operatives (co-operatives). This engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report.

We therefore make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested, or for any other purpose.

Procedures:

- 1) Obtain an understanding of controls governing the receipt of funds by KDE from co-operatives.
 - A) Complete a walk-through of the receipt process and obtain documentation that supports the process.

Procedures (continued):

- B) Document our understanding of the process used by KDE to receive money from the co-operatives.
 - C) Conduct additional audit procedures for noted exceptions in receipt activity during planning.
 - D) Select a sample of receipts (or select all receipts, depending on total volume of receipts) and review the supporting documentation to ensure adherence to applicable processes.
 - E) Note and complete a written analysis of any control weakness or exception.
- 2) Obtain an understanding of controls governing the disbursement of funds from KDE to the co-operatives.
- A) Complete a walk-through of the disbursement process and obtain documentation that supports the process.
 - B) Document our understanding of the process used by KDE to disburse money to the co-operatives.
 - C) Conduct additional audit procedures for noted exceptions in disbursement activity during planning.
 - D) Select a sample of disbursements (or select all disbursements, depending on total volume of disbursements) and review the supporting documentation to ensure adherence to applicable processes.
 - E) Note and complete a written analysis of any control weakness or exception.

The findings noted during the performance of these procedures are contained in the attached audit report.

We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the use of KDE and its management, and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes. However, this report is a matter of public record and its distribution is not limited.

Independent Auditor's Report

Certain KDE controls over receipts are not consistent with best practices

Checks received by KDE should be restrictively endorsed immediately upon receipt. KDE does not restrictively endorse checks received from the co-operatives or other entities. The presence of a restrictive endorsement would reduce the likelihood that a check is misappropriated.

Additionally, the recording and custody functions of receipts processing are not segregated. Currently, only some divisions within KDE prepare a transmittal listing of checks received. All divisions forward checks to the KDE Financial and Materials Management Division. KDE Financial and Materials Management Division personnel are currently responsible for recording a receipt in the Management Administrative and Reporting System (MARS) and forwarding the actual check to the Office of the State Treasurer. Segregation of these duties would also reduce the likelihood that a check is misappropriated.

Recommendations

We recommend that KDE implement the following procedures to be consistent with best practices:

- Restrictively endorse all checks received at the point of receipt.
- All KDE divisions should employ consistent receipt procedures. A transmittal listing should be prepared within each division receiving a check. The division should then forward the transmittal listing to the KDE Financial and Materials Management Division to record the receipts in MARS. The KDE Division of Budgets should be assigned the responsibility of receiving checks from the divisions and forward the checks to the Office of the State Treasurer.

KDE does not adequately monitor co-operative disbursements

In November 1999, procedures were implemented by the KDE Division of Budgets to monitor disbursements by co-operatives for KDE programs. While these procedures address the previous absence of KDE oversight of the co-operatives disbursement of KDE funds, the procedures are not consistently followed, reducing their effectiveness. During the examination of Badgett Regional Co-operative disbursement monitoring, three disbursements totaling \$543 were noted in which the advance approval called for in the

monitoring procedures was not documented. These disbursements constituted 4.8% of the total \$11,336 disbursed as of the May 22, 2000, date of testing. In examining KDE's monitoring of the Kentucky Valley Educational Co-operative disbursements, one disbursement for \$550 was noted which was not supported by an invoice. This disbursement constituted 20% of the total \$2,750 disbursed as of the date of testing. Inconsistent application of established procedures exposes KDE to the continued risk of fraudulent activity.

The KDE Division of Budgets receives all program administration reporting from the co-operatives. Each level of KDE management also has access to MARS financial activity reports. Currently, KDE is verbally instructing each division director to begin using the MARS reports as part of his/her program monitoring activities. The KDE control environment would be enhanced by instituting a formal policy requiring each division director to monitor the financial activity of programs for which the director is responsible. Previously, the establishment of a \$300,000 grant to a co-operative without the knowledge of program personnel contributed significantly to an act of embezzlement within KDE. Oversight of co-operative administration of KDE programs by multiple departments and management levels within KDE would create an internal system of checks and balances, reducing the likelihood that such an error or irregularity will go undetected.

In order to cover the costs of administering a program, co-operatives receive administration fees from KDE. Typically, these administration fees range between 3% to 5% of the grant amount. For example, KDE paid the Elizabethtown School District a fee of \$3,900 in consideration for the Elizabethtown School District writing one check. Fixed rates have also been used for administration fees. For example, the Ohio Valley Educational Co-operative (OVEC) was paid \$550 per employee to administer payroll for personnel performing management services for KDE. These administration fees are negotiated at the discretion of program personnel in each Master Agreement without the benefit of a formal policy. The existence of such a policy would enhance the control environment by providing a consistent rate of administration fees reducing the risk of abuse.

Additionally, the co-operatives do not share direct accountability for adherence to the monitoring procedures. Providing the co-operatives with clear responsibilities and accountability for KDE program administration would reduce the likelihood that an error or irregularity will go undetected. Requiring a co-operative to reimburse KDE for expenditures made by the co-operative that do not adhere to established procedures will encourage accountability.

Recommendations

We recommend that KDE enforce policies that encourage consistent adherence to monitoring procedures and implement the following new procedures:

- Execute General Service Agreements with co-operatives that include:
 - Formal monitoring terms that require the co-operative to (1) obtain advance approval from the KDE Division of Budgets of proposed expenditures; (2) examine sufficient supporting documentation such as invoices, timesheets, and training attendance documentation prior to initiating a disbursement; (3) obtain approval from KDE Division of Budgets to disburse funds based on supporting documentation; and, (4) submit interim and final program administration financial reports to both the respective Program Director and the KDE Division of Budgets. The Program Director will thus actively manage program expenditures, and the Division of Budgets will provide oversight by periodically comparing these reports to KDE program records.
 - The use of Master Agreements should be required whenever services are rendered. The Master Agreement should require the co-operative to document through written notification and approval of the Commissioner of Education and the future KDE Internal Auditor whenever deviation from agreement terms is proposed. This will prevent the reoccurrence of establishing grants solely through the use of a purchase order.

- Add a term to the standard Master Agreement that requires compliance with the General Service Agreement and assigns financial responsibility to the co-operative for disbursements that do not comply with agreement terms.
 - Develop a formal policy assigning the responsibility of each division director to use available MARS financial activity reports to monitor his/her program activities.
 - Create a formal administration fee policy including limits and guidelines for determining an appropriate fee rate.
-

KDE diminishes its control over financial transactions by observing improper delegations of authority

As part of our testing we examined 16 Master Agreements governing KDE disbursements made to co-operatives. In 10 of the Master Agreements tested, Mary Ann Miller, Kentucky Board of Education Policy Coordinator, signed on behalf of the Commissioner of Education. This authority to approve Master Agreements on the Commissioner's behalf was delegated to Miller indirectly. Disbursements from Master Agreements authorized under this delegation of authority continued as late as April 26, 2000.

In June 1995, Kevin Noland, then Interim Commissioner of Education prior to the appointment of Wilmer Cody as Commissioner of Education, delegated via the Commonwealth's Standard Comparative Signature Card Form his authority to approve Master Agreements to Deputy Commissioner Randy Kimbrough. Though Commissioner Cody began work at KDE in August 1995, Kimbrough delegated via the form identified above Commissioner Cody's authority to approve Master Agreements to Miller in July 1996.

While these acts of delegation apparently do not violate KDE policy, they are inconsistent with best practices and pose an ongoing risk that Master Agreements will be improperly authorized. The power to delegate one's authority to another is personal to the delegator. It should not be exercised by another. In addition, delegations of authority should only be effective until the delegator revokes the delegation or vacates the position of authority. For example, all delegations of the Commissioner's authority granted by Noland, including the delegation to Kimbrough in June 1995, should have expired when Noland ceased serving as Interim Commissioner.

Former Commissioner Wilmer Cody should have signed at his discretion subsequent delegations of his authority as Commissioner. This would maintain the integrity of the authorization process, and ensure that individuals always have knowledge of and control over those to whom their authority is delegated.

Recommendations

We recommend that KDE observe a formal policy that prohibits attempts to delegate the authority of others, and voids all delegations granted by an individual once the person vacates the position of authority.

KDE should continue to seek increased qualifications for its financial management positions to effectively monitor internal controls

The KDE organizational structure places the Office of Budget and Financial Management under the supervision of the KDE Deputy Commissioner of the Bureau of Management Support Services. This supervisory position enabled the previous Deputy Commissioner to redirect KDE funds solely on her authority. The Deputy Commissioner should not have the unilateral authority to initiate financial transactions involving state funds. The Office of Budget and Financial Management is charged with following procedures to assure only properly authorized transactions are initiated.

Current managerial personnel within the Office of Budget and Financial Management have business educations and backgrounds. However, the minimum requirements for candidates for these positions specify no formal accounting, business education, or experience as a pre-requisite for employment. To soundly administer a \$3 billion budget, best business practices dictate that KDE assure the hiring of highly qualified business and accounting professionals.

Recommendations

We recommend the system of controls at KDE prohibit the Deputy Commissioner of the Bureau of Management Support Services or any other KDE managerial official from initiating financial transactions at their sole direction or authority. A properly designed internal control system segregates the functions of processing and authorizing transactions and access to assets.

We recommend KDE ensure that key positions of the Office of Budget and Financial Management are staffed with personnel trained and experienced in accounting or a business or finance related field. Furthermore, a master's degree in a business related field or professional certification are recommended qualifications.

We issued two interim reports, dated February 28 and April 17, 2000, communicating findings and recommendations arising from our special examination of the circumstances surrounding a fraud at KDE and other matters involving the co-operatives. Our special examination contributed significantly to the efficient completion of this engagement, which was completed in just over half of the hours originally estimated for completion. In addition to the Memorandum of Agreement governing the procedures discussed in the preceding pages, we offer the following comments and recommendations as a follow-up to our earlier interim reports.

**Past-due occupational
license fees or taxes
calculated to be owed to
all eligible local
governments should be
paid**

We reported in our February 28, 2000, interim special examination report that KDE management employees paid through contract with OVEC had failed to pay local occupational license fees to the City of Frankfort and other localities. KDE had relied on a 1992 internal legal opinion made without consulting city officials. After receiving an Attorney General's Opinion on May 19, 2000, that sided with the city, KDE has agreed to remit \$298,520.77 to the City of Frankfort for taxes due from 1991 through 1999. KDE will seek payment from the individual employees involved.

KDE has not agreed to pay any penalties or interest, which we had estimated at over \$97,000, citing undue hardship on its current and former employees. The attached letter from the interim KDE Commissioner details the request by KDE to the city to be exonerated from paying the interest and penalty. See Attachment.

In addition to the amount owed to the City of Frankfort, we identified over \$100,000 in local occupational taxes owed to other communities. KDE has agreed to pay the net amount due to each of the communities involved but has again asked that any penalty and interest be waived.

**KDE should seek the
return of unexpended
grant balances**

The interim report dated April 17, 2000, noted that KDE-controlled funds granted to the co-operatives and local school districts were being held past the expiration date specified in the grant agreements. The interim commissioner agreed to comply with our recommendation that all such funds be returned to KDE for lapsing to the general fund at the end of the fiscal year. We note that near the end of the 1999-2000 fiscal year, over \$1,000,000 in unexpended KDE grant money remains at the co-operatives and two local school districts. Examples of these grants are as follows:

- The Kentucky Educational Development Corporation (KEDC) holds approximately \$633,000 in project accounts previously controlled by former Associate Commissioner Randy Kimbrough.
- The Kentucky Valley Educational Co-operative received a grant of \$102,000 on February 4, 2000, for a principal academy. The sole charge to this grant, initiated by KDE in September 1999, is the co-operative's administrative fee of \$5,000. The grant period for expenditure of this money expires June 30, 2000.
- The Ohio Valley Educational Co-operative continues to hold \$104,000 from a 1997 KDE grant. As we reported in our February 28, 2000, interim special examination report, the \$104,000 remains from a \$169,612 grant "parked" by KDE at OVEC so that KDE would not have to lapse these funds to the Commonwealth's general fund as required by KRS 45.229.
- The Elizabethtown and Oldham County school districts continue to hold KDE grant money totaling approximately \$170,000, which, according to the grant agreements, was to be expended by June 30, 1999.
- As noted in the April 17, 2000, interim special examination report, the Elizabethtown and OVEC grants, as well as other grants, were used by KDE to make payments to The National Faculty (TNF). TNF is an Atlanta-based non-profit organization that markets professional development services. KDE circumvented the Commonwealth's Model Procurement Code by directing payments totaling \$300,000 to TNF without having a written contract for services.

The OVEC and school district grants cited above are examples of grants from prior fiscal years that should already have been returned to KDE and lapsed to the general fund, as these funds may not be obligated past the expiration of their grant periods. Also, several co-operatives have substantial balances in fiscal year 2000 training grants for which charges are being made this summer.

Several of the co-operatives we spoke with indicated that they were aware that grant money unexpended by June 30, 2000 needed to be returned to KDE. However, the co-operatives had not received instructions from KDE to return unexpended funds.

Recommendation

We recommend that KDE require the co-operatives and school districts holding money from expired grant periods to return these unexpended balances to KDE. Charges against fiscal year 1999-2000 grants should only include expenses obligated by June 30, 2000.

The timely hiring of an internal auditor is essential

We reaffirm our belief that KDE must establish an independent, properly staffed internal audit function to assure a strengthened control system. The Kentucky Board of Education (Board) voted on March 30, 2000, to establish the internal audit position. A KDE official represented to us that interviews for this position are scheduled for July 2000, and anticipates filling the position in August.

An internal auditor organizationally independent from KDE is not only essential to the control environment at KDE but also to the sound fiscal control between KDE and the co-operatives. The internal auditor provides an avenue for co-operatives to report activity conducted outside of established procedures, as previously stated on page five of this report.

Recommendation

We recommend that KDE proceed with due diligence to make its internal audit function operational. Further, the internal auditor should have direct communication with the Board and attend and participate in Board meetings where audit oversight is discussed. Controls placed in effect by KDE and those recommended by this office can be objectively and routinely monitored when the independent internal auditor is in place.

Very truly yours,



Edward B. Hatchett, Jr.
Auditor of Public Accounts



KENTUCKY DEPARTMENT OF EDUCATION

CAPITAL PLAZA TOWER 500 MERO STREET FRANKFORT, KENTUCKY 40601

Kevin M. Noland, Interim Commissioner
(502) 564-3770

June 6, 2000

Ken Thompson, City Manager
City of Frankfort
315 West Second Street
Frankfort, Kentucky 40601

Dear Mr. Thompson:

In compliance with the May 19, 2000, opinion issued by the Attorney General concerning educational cooperative employees and local occupational tax liability, the Kentucky Department of Education (KDE) intends to ensure full payment occurs to the City of Frankfort for previously untaxed wages for calendar years 1991 through 1999. These taxable wages have been assessed at the prevailing rate that was in effect during those years (1 percent) and will be paid in full by August 31, 2000.

The department did not withhold the occupational tax from its Ohio Valley Educational Cooperative employees due to a legal opinion rendered in 1992 and relied upon in good faith. The individual's tax payments alone will present a hardship on many of our current and former employees. The penalty and interest assessment would create an extreme and undue burden on individuals who were innocent in this interpretation of the local ordinance. KDE respectfully requests exoneration of the interest and penalty, except for any individual employee who does not meet our deadline of August 15, 2000 for payment to KDE. KDE will verify the payments received, account those receipts to the taxes owed, and transmit the total owed to the City of Frankfort on or before August 31, 2000. The total tax due of \$298,520.77 will be made in one payment through the Kentucky State Treasury.

We greatly appreciate your consideration, time and patience in trying to reconcile this problem. Please contact me at 564-3141 if you have questions or need further information from the department.

Sincerely,

Kevin M. Noland

Kevin M. Noland

KMN:GAB:bgp

Attachment: Local Tax Calculations

Cc: Rex Hunt

KENTUCKY DEPARTMENT OF EDUCATION RESPONSE
AND
AUDITOR OF PUBLIC ACCOUNTS REPLY



KENTUCKY DEPARTMENT OF EDUCATION

CAPITAL PLAZA TOWER 500 MERO STREET FRANKFORT, KENTUCKY 40601

Kevin M. Noland, Interim Commissioner
(502) 564-4770

July 31, 2000

Edward B. Hatchett, Jr.
Auditor of Public Accounts
Capitol Annex Suite 144
Frankfort, Kentucky 40601-3448

RE: MOA 00034626- Report on Applying Agreed upon Procedures for Kentucky Department of Education (KDE)

Dear Auditor Hatchett:

I wish to thank you for the efforts of your staff, reports you have provided, and the excellent exit review that was conducted by Mr. Brian Lykins and staff. Mr. Lykins indicated that the Department of Education would have until Monday, July 31, to respond to the draft findings and recommendations that were provided in the audit exit interview. Our response is provided below.

Your first recommendation on page 3 states, " We recommend that KDE implement the following procedure to be consistent with best practices: Restrictively endorse all checks received at the point of receipt."

Response: The Department of Education understands and concurs with the finding.

Recommendation: "All KDE divisions should employ consistent receipt procedures. A new transmittal listing should be prepared within each division receiving a check. The division should then forward the transmittal listing to the KDE Financial and Materials Management Division to record the receipts in MARS. The KDE Division of Budgets should be assigned the responsibility of receiving checks from the divisions and forward the checks to the Office of the State Treasurer."

Response: Presently, a thorough separation of duties and responsibilities exist in the receipt processing procedures of KDE as evidenced in the previous eleven years of audits conducted by the Auditor of Public Account's Office. However, the KDE always with an eye toward improvement, agrees to develop a new transmittal listing form to be completed by the receiving offices. All checks will be forwarded to the Division of Financial and Materials Management, transmittal forms will be forwarded to the Division of Budgets, appropriate MARS documents will be prepared and transmitted by the Division of Financial and Materials Management with the checks to the Kentucky State Treasurer, and an independent reconciliation of the checks and transmittal forms will be completed by personnel in the Office of Budget and Financial Management who do not have any responsibilities for handling or transmitting the receipts. This will

ensure thorough and complete separation of duties and provide independent reviews for all receipt transactions.

Auditor's Reply: We concur that the implementation of the procedures proposed by KDE will result in the strengthened controls envisioned in our recommendation, provided that personnel independent of other steps in the process perform each task.

Recommendation: "We recommend that KDE enforce policies that encourage consistent adherence to monitoring procedures and implement the following new procedures: Execute General Service Agreement with cooperatives that include: ..." formal monitoring terms and use of Master Agreements.

Response: The KDE understands the recommendation and intends to execute General Service Agreements with each cooperative. Your draft report also states that Master Agreements should be required whenever services are rendered. It has been the intent of the Department of Education, with the passage of HB460 effective July 15, 1998, to enter into Master Agreements with each public entity and Personal Service Contracts with private providers for services where funds are transferred to these entities or organizations.

Recommendation : "Add a term to the standard Master Agreement that requires compliance with the General Service Agreement and assigns financial responsibility to the cooperative for disbursements that do not comply with agreement terms."

Response: The Department of Education understands and will comply with this recommendation. It also needs to be noted that a standard clause has been added to Department of Education Master Agreements that requires monitoring by KDE programmatic staff and submission of financial reports by the provider to the KDE for review.

Recommendation: "Develop a formal policy assigning the responsibility of each division director to use available MARS financial activity reports to monitor his/her program activities."

Response: The KDE expects division directors to review MARS financial activity reports, balance budgets, and use this information to plan their program activities and responsibilities. KDE will require this approach via inclusion of this responsibility in each Division Director's job description. Training on this subject has been and will continue to be given to all management personnel by the Office of Budget and Financial Management.

Auditor's Reply: We recognize in our report that "KDE is verbally instructing each division director to begin using the MARS reports as part of his/her program monitoring activities." In addition to merely disseminating elements of the control structure to personnel documents such as job descriptions, controls governing financial processes should be clearly defined in the KDE policies and procedures manual.

Recommendation: "Create a formal administration fee policy including limits and guidelines for determining an appropriate fee rate."

Response: KDE will reaffirm policy to our contractors plus keep a copy of the policy on file. The KDE believes that the indirect cost rates in local school districts and the set maximum rate of 8% for public institutions of higher education address this recommendation. Please note that rates for local school districts are set through a negotiating process with each district and the KDE's District Support Services, Division of School Finance. Each Master Agreement instituted with local school districts adheres to the rates established by these two organizations. Rates vary from school district to school district based on their actual cost and the financial circumstances of each district peculiar to itself. The Master Agreements with public institutions of higher education are set at an 8% maximum rate.

Auditor's Reply: As confirmed by Division of Budgets personnel, no formal policy existed that either limited the amount or delineated the manner in which the amount of administrative fees earned by the co-operatives was determined. Existing guidelines pertaining to local school districts and public institutions of higher education may be useful in establishing a formal policy toward the co-operatives. However, we again caution against allowing co-operatives excessive fees not commensurate with the administrative work provided.

Recommendation: "We recommend that KDE observe a formal policy that prohibits attempts to delegate the authority of others and voids all delegations granted by an individual once that person vacates the position of authority."

Response: In the one instance in 1996 to which you refer, the Deputy Commissioner of Management Support Services delegated a prior delegation of authority from the Interim Commissioner of Education to another individual. This particular delegation was an error in judgment by a former employee. It will not be allowed to happen again.

Auditor's Reply: We agree with KDE management that this delegation of authority was in error. However, without a written policy personnel do not have sufficient information to properly monitor authorizations. While this delegation of authority originated in 1996, numerous financial transactions, extending through fiscal year 2000, were approved based on that delegation.

Recommendation: "We recommend the system of controls at KDE prohibit the Deputy Commissioner of the Bureau of Management Support Services or any other KDE managerial official from initiating financial transactions at their sole direction or authority. A properly designed internal control system segregates the functions of processing and authorizing transactions and access to assets."

Response: KDE understands and concurs with the recommendation. No staff that authorizes a payment transaction will be allowed to direct assets returned to the department. There will be a separation of these responsibilities. This situation will be addressed in the General Services Agreements with cooperatives. If an individual were to request a deviation from policy, it would be the cooperatives' responsibility to question the Department of Education seeking clarification. The internal auditor will be responsible for answering these questions.

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Recommendation: "We recommend KDE ensure that key positions of the Office of Budget and Financial Management are staffed with personnel trained and experienced in accounting or a business or finance related field. Furthermore, a masters' degree in a business related field or professional certification are recommended qualifications."

Response: As your findings indicate, the managerial staff in the Office of Budget and Financial Management namely, the office head and two division directors (each of whom has a minimum of bachelors degree in economics or business administration) have backgrounds necessary beyond minimum state requirements. One has an MBA, one has a BBA with the Association of Governmental Accountant Certificate for Certified Governmental Financial Manager, and one has an economics degree. These adequate credentials coupled with their total 60 plus years of extensive field experiences allow for the thorough management of KDE's budget. You further state that minimum requirements for candidates for these positions specify no formal accounting or business education. I believe that you are speaking about future candidates if vacancies should occur. I agree that KDE managerial staff should have qualifications that exceed minimum qualifications required through the Personnel Cabinet. Again, the staff in the Office of Budget and Financial Management do have qualifications in excess of the minimum and are sound financial managers.

Recommendation: On page 8, you speak of occupational taxes that had not been withheld by the Ohio Valley Educational Coop from payrolls of managerial employees of the Department of Education.

Response: KDE has already sought payment of these occupational taxes from its present and past employees. These funds are due and payable on or before August 15, 2000. Transmittal of the total amount due to the city of Frankfort and to all other cities where occupational taxes should have been withheld will be made on or before August 31, 2000. We discovered that occupational taxes had not been withheld from cities other than Frankfort. KDE instituted correspondence with the other occupational tax entities. The Department of Education is fully implementing the Attorney General's opinion. The taxing entities have agreed to waive penalties and interest upon full payment of back occupational taxes by August 31, 2000.

Auditor's Reply: Our office reported to KDE on February 28, 2000, that occupational license fees for KDE management employees under contract with OVEC were not withheld and paid to numerous communities for over eight years. Further, we recommended at that time the City of Frankfort and all other localities for which occupational license fees are levied should be contacted to determine the amount of delinquent taxes that should be paid.

While we acknowledge the efforts of KDE to collect and remit past occupational taxes, we at the same time regret the burden placed on affected employees to remit years of these taxes in one lump sum. We would again point out this burden resulted from KDE's reliance on an errant KDE internal opinion rendered in 1992 absent inquiry of the local communities or an independent Attorney General's Opinion.

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Recommendation: The next recommendation is found on page 8 and states: "The interim report dated April 17, 2000, noted that KDE controlled funds granted to the cooperatives and local school districts were being held past the expiration dates specified in the grant agreements."

Response: KDE previously indicated intent to comply with this recommendation and was waiting on the APA's final report on this issue to implement (Attachment 1). The KDE has send a letter to the cooperatives and the appropriate school districts (Attachment 2) to accomplish return of the appropriate fund balances for lapsing to the General Fund.

Issue: "The Kentucky Education Development Corporation (KEDC) holds approximately \$633,000 in project accounts previously controlled by former Associate Commissioner Randy Kimbrough."

Response: The KEDC has had funds frozen by the Interim Commissioner of Education awaiting recommendations in this report. The Interim Commissioner of Education is now directing all frozen funds be returned to the Department of Education for lapse to the General Fund.

Issue: "The Kentucky Valley Educational Cooperative received a grant of \$102,000 on February 4, 2000, for a Principal Academy. The sole charge to this grant initiated by KDE in September 1999, is the cooperative's administrative fee of \$5,000. The grant period for expenditure of this money expires June 30, 2000."

Response: Master Agreement M-99096120 with Kentucky Valley Educational Cooperative in Hazard, Kentucky, was for \$102,000 for Principal Academies. This contract had an effective start date of November 1, 1999, and the \$102,000 payment was transmitted on February 1, 2000. The Interim Commissioner of Education, as previously stated, is directing the return of all unspent grant funds to the Department of Education to be lapsed into the General Fund.

Issue: "The Ohio Valley Educational Cooperative (OVEC) continues to hold \$104,000 from a 1997 KDE Grant. As we reported in our February 28, 2000, interim special examination report, \$104,000 remains from \$169,612 grant parked by KDE at OVEC so that KDE would not have to lapse these funds to the Commonwealth's general fund as required by KRS 45.229."

Response: The Interim Commissioner of Education, in January 2000, notified cooperatives that funds would be frozen until a response was received from the audit that he requested through the Auditor of Public Accounts. A letter is being sent to the OVEC executive director requesting a return of all funds unspent as of COB June 30, 2000.

Issue: "The Elizabethtown and Oldham County School Districts continue to hold KDE grant money totaling approximately \$170,000, which according to the grant agreements was to be expended by June 30, 1999."

Response: As indicated above, the Interim Commissioner of Education is issuing a letter to all educational coops and to these two school districts for the return of any unused grant funds that had balances remaining as of June 30, 2000, then these funds will be transferred to the General Fund by KDE.

Issue: "As noted in the April 17, 2000, interim special examination report, the Elizabethtown and OVEC grants, as well as other grants, were used by KDE to make payments to The National Faculty (TNF). TNF is an Atlanta non-profit organization that markets professional development services. KDE circumvented the Commonwealth's Model Procurement Code by directing payments totaling \$300,000 to TNF without having written contract for services."

Mr. Edward B. Hatchett, Jr.
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Response: Please refer the Interim Commissioner's letter of April 18, 2000 (Attachment 1), for KDE's response. In addition to the statements in the letter, this was an isolated incident that is contrary to the usual practices of KDE when entering into financial transactions. KDE does not intend for this to happen again. Normal KDE practice requires the use of Memorandum of Agreements and Personal Service Contracts for those appropriate transactions.

Auditor's Reply: The specific grants cited by the APA as subject to lapsing to the general fund are prominent examples of unspent KDE funds held at the co-operatives. The newly cited KVEC grant reported above, as well as other grants not specifically identified in our reports, are all subject to the lapsing provisions of KRS 45.229. We trust that KDE will ensure that all applicable, unobligated funds are returned from the co-operatives and school districts now and in the future.

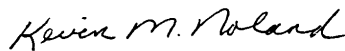
Your last recommendation states that KDE should proceed with due diligence to make its internal audit function operational .

Response: At its March 2000 Meeting, the Kentucky Board of Education (KBE) concurred with the recommendation of the Interim Commissioner of Education to establish a new internal auditor position within the KDE that answers directly to the Commissioner and to the KBE. Presently, applications have been reviewed and interviews with the candidates were held on July 20. It is my hope that an individual will be recommended and approved by the Interim Commissioner and the KBE by August 2, 2000.

I hope that these responses will be helpful to you in correcting the misunderstandings in the draft APA report. Additionally, this letter is to confirm the steps KDE has taken, is taking, and will take to implement recommendations as noted above. We truly appreciate your assistance in this matter.

If you have any questions or need additional information, please contact me at 564-3141 or Glen A. Bradt, Associate Commissioner, Office of Budget and Financial Management, at 564-1976.

Sincerely,



Kevin M. Noland

Attachments

C: Glen Bradt



Attachment 1

KENTUCKY DEPARTMENT OF EDUCATION

CAPITAL PLAZA TOWER 500 MERO STREET FRANKFORT, KENTUCKY 40601

Kevin M. Noland, Interim Commissioner
(502) 564-4770

April 18, 2000

Mr. Edward B. Hatchett, Jr.
Auditor of Public Accounts
144 Capitol Annex
Frankfort, Kentucky 40601-3448

Dear Auditor Hatchett:

Thank you for your letter dated April 17, 2000. We appreciate the work of your office. For the most part, these matters were previously reported; for example, the amount identified as having been embezzled by Randy Kimbrough has not increased. Additionally, the issue as to the Department of Education near the end of prior fiscal years granting money to some educational cooperatives, and that money being used for educational purposes during the rest of the summer and into the next fiscal year, has been a concern you had previously reported. We appreciate you identifying technical concerns about managerial practices, and you will be pleased to know that the concerns you have raised have already been addressed.

In your letter, you report some concerns as to how the paperwork was handled in relation to the teacher training institutes conducted by the National Faculty (TNF). TNF is a nationally known private, non-profit, organization that has a unique model for teacher institutes that has been widely acclaimed. There is no doubt that the services provided by TNF for the teachers was actually provided and have been very well received by those teachers. A further explanation of the services provided are found in the attachment.

Much of what you have reported relates to financial transactions that accumulated over the last three years. You will be pleased to know that leadership in KDE has always received accounting and budgetary reports from the KDE Office of Budget and Financial Management on a monthly basis and upon demand. However, we have also strengthened that process for monitoring. The new procedure includes required financial reports on a regular basis from the grantee. Additionally, the improved monitoring as to grants is further described in the attached chart.

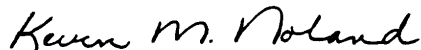
April 18, 2000
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You have my assurance that at the close of this fiscal year, any remaining financial balances that are not under contractual obligation will lapse to the general fund. This should result in better planning for everyone involved, and even though it may result in having to process two contracts for summer training activities that cross fiscal years, this is the better approach under state contracting procedures. Additionally, you have my assurance that any funds granted by KDE to an educational cooperative or a local district for which uncommitted balances remain upon the closing of the fiscal year will be returned to KDE for lapsing to the general fund.

As to the Internal Auditor position within KDE, I am very pleased to hear that you support the action taken by the Kentucky Board of Education on March 30 to establish the Internal Auditor position, as recommended by the Interim Commissioner of Education. The attached report, which reflects the research leading up to this recommendation, includes the Institute of Internal Auditors Standards as part of this approach. Your recommendations relative to the Internal Auditor are consistent with the actions that have already been taken.

Over the last three months, KDE has offered the full cooperation of its employees and opened its books to enable the state auditor to review thousands of documents. The focused review by your office has enabled the identification of some concerns and recommendations for improvement that have not been identified in prior annual audits. We appreciate this focused review, and continue to offer our assistance and cooperation. Please let me know if you have any questions.

Sincerely,

A handwritten signature in dark ink, reading "Kevin M. Noland". The signature is written in a cursive, slightly slanted style.

Kevin M. Noland

attachments



KENTUCKY DEPARTMENT OF EDUCATION

CAPITAL PLAZA TOWER 500 MERO STREET FRANKFORT, KENTUCKY 40601

Kevin M. Noland, Interim Commissioner
(502) 564-4770

July 20, 2000

Dr. John A. Rosati, Chief Executive Officer
Ohio Valley Educational Cooperative
100 Alpine Drive
Shelbyville, Kentucky 40065

Dear Dr. Rosati:

I want to take this opportunity to thank each of you for patiently waiting with me for the results of the Auditor of Public Accounts' internal review following the Randy Kimbrough embezzlement. As you may be aware, I requested an internal review of controls of the Department of Education by the Auditor of Public Accounts so that I could be assured that no other financial problems would be encountered.

I have just received the draft response from the Auditor's office. One of their recommendations is as follows: "We recommend that KDE require the cooperatives and school districts holding money from expired grant periods to return these unexpended balances to KDE. Charges against fiscal year 1999-2000 grants should only include expenses obligated by June 30, 2000." We concur with the recommendation and are seeking repayment of all funds that I have previously frozen and other grant funds that may have been sent to you during Fiscal Year 2000 in which unobligated balances still remain. Please make a check payable to the Kentucky State Treasurer. Return it to my attention with a full accounting of each grant to include the original amount of the grant, the expenditures made to date, the purpose of the expenses, the remaining balance, and reasons why the contract did not complete. I need your reply and check no later than August 15, 2000.

Again, I thank you for your patience and for the partnerships that we have conducted throughout the years for the genuine good of students and education throughout the Commonwealth. Should you have any questions about this letter and its contents, I ask that you please call me at 564-3141 or Glen Bradt at 564-1979.

Sincerely,

Kevin M. Noland

Kevin M. Noland

KMN:GAB:khs